

Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return on the investment portion of such products than is available on investments whose income is fully taxed on a current basis. The Administration proposals would do away with this special treatment. Deferral of tax on the investment income earned on a life insurance policy (other than a term insurance policy) would be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance company deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE
INSURANCE INSIDE BUILD-UP

General Explanation

Chapter 10.06

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns income for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as investment income is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the policy have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in

exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance for past periods. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment products offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment product, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Earnings on comparable investment products generally are not tax free or tax deferred. Instead, income credited on such investments generally is subject to tax whether or not the income is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures, and on investment income from mutual funds even if the income is credited in the form of additional fund shares.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside build-up encourages individuals to save through life insurance companies rather than other

financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies (other than variable life insurance policies) would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy. In the case of variable life insurance policies, the policyholder would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable policy. The policyholder thus would not be taxed on the unrealized appreciation of assets underlying a variable policy. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all inside build-up credited on or after January 1, 1986 to policies issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. Inside build-up would continue to be free from tax in the case of policies issued before the date of Committee action to the extent that the death benefit of the policy does not exceed the death benefit on the date of Committee action plus any additional death benefit required for the policy to continue to satisfy the definition of life insurance under current law.

Analysis

Taxing the inside build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Taxation of inside build-up also would eliminate the need under current law for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred income earned on life insurance and annuity policies in 1983 is estimated at \$3,050 for families with income greater than \$200,000 and less than \$200 for families with income less than \$30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 10.06-1

Distribution of Ownership of Cash-Value Life
Insurance Policies and the Annual Inside
Interest Build-up 1/
By Economic Income - 1983

Family Economic Income	Percentage of Families with Cash-Value Life Insurance Policies	Average Annual Inside Buildup <u>2/</u>
\$ 0 - 9,999	13 %	\$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42 %	\$ 355

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1/ Includes annuities.

2/ For those with policies.

IMPOSE CURRENT TAXATION ON DEFERRED
ANNUITY INVESTMENT INCOME

General Explanation

Chapter 10.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposit and investment income from mutual funds is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts ("IRAs"). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller and more easily avoided withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts (other than variable contracts) would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract. In the case of variable deferred annuity contracts, the contract owner would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. The owner thus would not be taxed on the unrealized appreciation of assets underlying a variable contract. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all investment income credited on or after January 1, 1986 to contracts issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. In the case of contracts outstanding before the date of Committee action, investment income credited to the contracts would continue to be untaxed until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions from contracts issued on or after the date of Committee action. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would encourage the efficient flow of long-term savings.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 10.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Ch. 10.06, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an account yielding an investment return. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy.

This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to pay to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserve for any contract generally would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). A special rule would be provided for current annuity contracts that may not be surrendered for cash.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Ch. 10.06, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 10.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first \$3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from \$3 million to \$15 million. The small company deduction is allowed only to companies with gross assets of less than \$500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base of competing financial institutions. Enactment of comprehensive tax reform affecting all financial institutions and reducing the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective maximum marginal tax rate to 36.8 percent. The Administration proposals would lower the top corporate rate to 33 percent. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate.

Small life insurance companies would be placed on a par with all other small corporations. Elimination of preferential tax rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor sales of life insurance through small firms.